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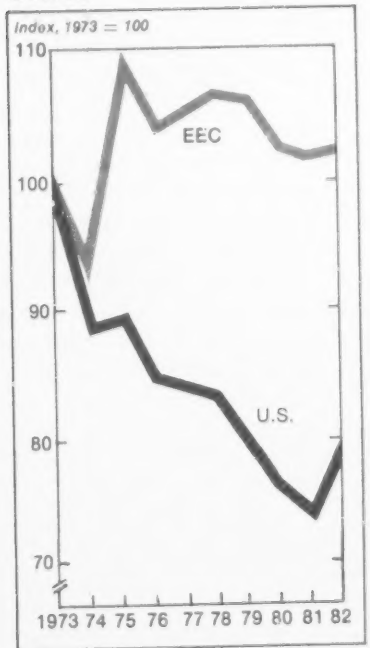
High Wages Dampen European Growth Prospects

High labor costs continue to cloud the medium-term growth prospects for Western Europe. Wages have risen more rapidly than prices in the manufacturing sector in Europe over the past 10 years, although there has been a tendency for the pace to slacken since 1979. In the United States, in contrast, manufacturing wages have risen somewhat more slowly than prices since 1973. This differential in the rate of change of real-wage costs is only partly consistent with differences in the rate of growth of labor productivity. While the increase in manufacturing labor productivity has been higher in Europe than in the United States, increases in productivity in Europe lagged behind advances in real wages during much of the 1970s. As a result, unit-labor costs in manufacturing—the labor cost of producing a given volume of output—although falling in recent years, still stand higher in real terms in most of the European economies than before the first OPEC price shock. The reverse is true for Germany and the United Kingdom, but even in those economies the post-1973 decline in real unit-labor costs still falls short of that of the United States.

The real cost of labor* in Europe and the United States



*unit labor cost in manufacturing adjusted for changes in industrial wholesale prices

Underlying this superior post-1973 U.S. performance in real unit-labor costs are major differences in labor market characteristics between the United States and Europe. In much of Europe there is a significant political influence over wage levels exercised through such devices as mandatory wage-indexing formulas, minimum-wage legislation, and pace-setting wage negotiations between the government and public-sector employees. In the United States, the influence of government policy over wage levels is far less. In addition, U.S. labor contracts are of a longer average duration than in Europe, resulting in a tendency for wages to lag behind prices in periods of accelerating inflation.

The steady upward drift of unemployment rates in Europe has forced a somewhat belated recognition of the problems created by excessive real-wage growth. In a number of countries where real unit-labor costs are particularly high relative to 1973 levels—Belgium, the Netherlands, Denmark, France, and Italy, for example—steps to achieve greater real-wage flexibility have been taken over the past year, mainly in the form of loosened or temporarily suspended wage-indexation formulas. These moves have been helpful, but unless further cuts in real wages are accepted or payroll taxes are reduced, excessive real labor costs will continue to act as a brake on potential growth in most of the European economies.

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Spain's economic policies turn restrictive.

After a long delay, Spain's 1983 budget has finally been presented to the Cortes. The document confirms that the new Spanish government is determined to place the financial and monetary sectors on a sound footing before directly addressing the growing unemployment problem. The budget projects an overall deficit of 1,100 billion pesetas—roughly equivalent to 5% of GDP and significantly lower than the 1,350-billion-peseta deficit initially indicated in the government's economic program. This involves an increase in income taxes and a reduction in the social security budget but an expansion in public-sector investment. Meanwhile, the authorities are effecting a restrictive monetary policy in order to reduce inflation from the 14% annual rate of 1982 to a targeted 12% in 1983. Required reserve deposits at the Bank of Spain have recently been raised to 4% of total deposits from 3% in an attempt to trim money-supply (M3) growth from a year-on-year rise of 16.3% in January to 13%. As a result, interest rates have come under upward pressure, with interbank rates now over 20%.

New Austrian government unlikely to change course.

The Austrian economy performed quite well last year in comparison with other European economies. Real output expanded by about 1% while inflation was held to 5.4%, and the current account swung to an 8-billion-schilling surplus. However, unemployment rose to 4.5% at the end of last year, almost double the year-earlier rate, and the public-sector deficit has grown rapidly. At this stage, Vice-chancellor Sinowitz is trying to form a coalition government, probably with the small centrist Freedom Party that now holds the balance of power. This follows the recent resignation of Socialist Chancellor Kreisky, who suffered an electoral setback. Whatever the outcome, Austrian economic policy is unlikely to undergo a radical transformation. There is a reasonably high degree of consensus among the political parties, and Austria is a small, open economy highly dependent on developments in the rest of Europe, especially in Germany. The economic outlook, therefore, is for a further decline in inflation, a modest pickup in economic growth, and a continuation of a slight current-account surplus.

Icelandic election fails to produce mandate for corrective economic policies.

Many Icelanders had hoped that the general election of April 23 would bring in a government with a clear mandate to enact tough policies to rectify its many economic problems: Inflation has remained near 50% and is in danger of reaccelerating. In addition, the critical fish catch is down sharply and the market for fish exports appears to be shrinking. Finally, Iceland's aluminum and ferrosilicon exports have been hard hit by the continuing global recession. GDP is expected to decline by about 3% this year after a 3.5% fall in 1982, while the current-account deficit will remain close to 11% of GDP. The election, however, failed to produce a clear winner. The ruling left-center coalition has officially resigned, but forming a new government will take time. Unless new elections are called that then produce a more decisive result, no new government is likely to have sufficient coherence to introduce the urgently needed corrective policies. Iceland's economy thus seems destined to remain in trouble for at least another year. And even then, any improvement will be heavily dependent on the strength of world recovery.

Chilean monetary authorities act to offset effects of reserve drain.

In the first quarter of 1983, Chile lost nearly $1 billion in net international reserves. Approximately 60% of the reserve loss was due to repayment of short-term debt. The rest of the drain could be traced principally to the financing of the current-account deficit and obligations excluded from the present freeze on foreign debt repayment. This loss in reserves could have caused a severe contraction in the monetary base, and thus, the money supply. The Chilean authorities, however, fully offset the potential reduction in the base by increasing domestic credit. Net domestic assets expanded from a negative 24.5 billion pesos in December to 51.2 billion pesos at the end of March. These developments, however, placed Chile in noncompliance with the IMF ceilings on net international reserves and net domestic assets for March. Nonetheless, by restricting domestic credit growth and by obtaining new funds from international commercial banks, the Chilean authorities intend to get back on track with the IMF program by September.

Costa Rica's balance-of-payments outlook improves.

Costa Rica's balance-of-payments problems are showing encouraging signs of receding. Recent reports are that the long debt-restructuring negotiations have been finalized and that the government and the commercial banks are expecting to sign a new agreement by May 30. The proposed agreement calls for the setting up of a revolving trade facility and a debt restructuring that includes past-due principal and payments due in 1983 and 1984. There also has been some unexpected good news on the trade balance. The fall in crude-oil prices has led to a reduction in the country's petroleum import bill, and the price of bananas—Costa Rica's main export—rose by 40% in the last quarter because of crop failures elsewhere. Finally the government's political detachment from Nicaragua's Marxists has bolstered domestic business confidence and improved Costa Rica's chances of receiving additional economic aid from the United States. The country's debt ratio will still exceed 50% in the years after 1985, but recent favorable developments should help Costa Rica ride out these difficult times.

Oil price drop spurs devaluation, could prompt development cutbacks in Indonesia.

On March 30, the Indonesian rupiah was devalued by 27.4% from 704 per U.S. dollar to 970. The move, which had been widely anticipated, became inevitable with the reduction in OPEC crude-oil prices earlier in the month. In the fiscal year just-ended March 31, the current-account deficit climbed to over $7 billion. And the oil-price cut threatened to widen the gap still further. Foreign-exchange reserves—including those held by state banks—dropped by about $4 billion to slightly above $6 billion. The new exchange rate reportedly was calculated as one that would return the competitiveness of Indonesian goods back to the level of November 1978—immediately following the last major devaluation. However, it is unlikely that the devaluation itself will be enough to remedy the balance-of-payments deficit, and cutbacks in some capital-development projects are possible. Although these measures would be painful, coming after sharp cuts in subsidies for fuel and food, the government nonetheless seems resolved to preserve Indonesia's creditworthiness and reputation for sound economic management.

New Zealand inflation-fighting tactics showing results at last.

The drastic measures instituted last year by the New Zealand government to bring rampant inflation under control finally appear to be taking hold. The persistence of double digit inflation—at a time when inflation rates in most of the other OECD countries were slowing markedly—was eroding New Zealand trade competitiveness and keeping the New Zealand dollar under severe downward pressure. Following a 15.3% rise in consumer prices in 1981, inflation hit an annualized rate of 21.6% in the second quarter of 1982. In an effort to reduce this dangerous trend, Prime Minister Muldoon tightened monetary policy dramatically and on June 22 enacted a one-year wage-price freeze. The nation's money supply fell in both the second and third quarters of 1982, and rose during the fourth quarter at an annual rate of only 3.6%. Nonetheless, New Zealand inflation remained stubbornly high relative to the rest of the OECD—15.2% and 11.1% in the third and fourth quarters, respectively. More recent statistics have been much more encouraging: Inflation in the first quarter of this year came in at an annual rate of 3.2%—far better than even the optimists could have hoped for.

Jordan moves to offset its reduced Arab funds transfers.

Although not an oil producer itself, Jordan has inevitably been hurt by the impact of the weak oil market on its Arab neighbors. Unofficial estimates show workers' remittances rising by only 12% in 1982 to $1.08 billion, down from 44% in 1981. Moreover, aid receipts, mainly from Arab states, appear to have declined by as much as 20% to $990 million. Partly as a result, the current-account deficit probably widened sharply to about $200 million from $42 million. The authorities, however, have responded positively. In the 1983 budget, the increase in overall spending was reduced to only 4%—with capital spending down by 12%. And the Jordanian economy remains in a strong position. Foreign-exchange reserves totaled $826 million in February, not counting about $450 million in gold. This provides a very comfortable coverage, equivalent to four-and-a-half months of imports.

Can the Bull Market Last?

The U.S. stock-market rally—already longer than most analysts had expected—is continuing. Despite some pauses in its upward climb, the Dow-Jones industrial index has soared 56% since last August—much faster than most of the stock-index advances in other major industrial countries. But while there are some strong fundamental reasons to expect the near-term trend to continue upward, the longer-term outlook is far more uncertain.

The most important boost to the stock market has come from the emergence of clear signs of economic recovery. For example, in the last four months U.S. industrial production has risen 3% and labor productivity has increased at an annual rate of 4.8%. As a result, first-quarter corporate operating profits are expected to have risen nearly 25% from their levels of a year ago.

The other major fundamental force behind the runup in stock prices is the favorable outlook for inflation—for the next year or so at least. During the 1970s, stock prices languished as accelerating inflation eroded real corporate profits. But with the Consumer Price Index expected to rise less than 4% this year, most of the gains in corporate profitability will be real.

There are, however, some indications that the stock market's performance may have been more exuberant than these fundamentals warrant. While stock prices typically rise before a recession's end, the magnitude of this rally is about twice as large as the rallies that began near the end of the 1969-1970 and 1973-1975 recessions—even though both earlier recoveries got off to a much faster start.

One possible explanation for the extraordinary strength of the current market may be the expectation of a longer-lasting slowdown in inflation. The improvements in inflation during and after the two recessions mentioned above were not nearly as dramatic as in the recent experience. Moreover, those earlier slowdowns in inflation rates proved to be only temporary.

A reemergence of rising inflation expectations would almost certainly preclude a prolonged stock market rally. And while the immediate outlook for inflation is quite favorable, there are some less-optimistic portents that bear watching. The rapid increase in the money supply since last August is one sign that faster inflation may lie ahead in the future. More immediately troubling is the rapid rise of certain commodity prices since last fall; in past recoveries, these prices did not start rising until a year or so into the recovery. A key clue for stock market followers trying to anticipate the end of the current rally would be the emergence of more-general price pressures. Such a development, combined with any signs that the recovery is even weaker than is now expected, could easily put an end to the great bull market of 1982-1983.

Douglas L. Bendt

The Rise and Fall of the Money Funds

The last decade has been marked by a number of financial-market innovations. The most prominent of these has been the creation of money-market mutual funds (MMMFs). In the past few years, this vehicle has become a significant source of investment funds and a catalyst for the transformation of the U.S. financial system. But now, as a new era of bank deregulation begins, the funds seem to have lost their luster. As each week passes, redemptions exceed sales and net asset levels fall.

The rise of this financial asset form resulted from the strict retention of Regulation Q by the Federal Reserve in a period of high and rising interest rates. By artificially restraining what a bank could pay on its deposits, an incentive was created for disintermediation or some form of arbitrage. By lending directly to borrowers or investing in bank deposit instruments exempt from ceilings investors could gain market rates of return. Into this opening, the MMMFs stepped. They provided a vehicle for the pooling of funds to purchase high-yielding money-market instruments.

Since December 14, when banks were first allowed to offer accounts yielding competitive rates of return, MMMFs have come under intense competitive pressure and assets have fallen sharply. Banks have been offering accounts that well match the returns or services available from MMMFs and that have the added attraction of federal deposit insurance.

In a regulated environment, it was the MMMFs that had the advantage. Now the situation is reversed. It is impossible for the funds to offer more-generous returns than the banks when their portfolio consists largely of government securities and bank instruments (certificates of deposit, bankers acceptances, and repurchase agreements, for example). The former do not earn enough, and the latter will not deviate from what banks would pay on individual deposit accounts.

To compete, the MMMFs must become more like banks. They will have to lend directly to industrial and commercial borrowers in order to earn returns capable of supporting competitive rates on investor balances. To further approximate the attraction of bank accounts, they must secure private insurance to reduce risks to investors.

But in achieving parity, another problem emerges. MMMFs are not designed for the task of allocating capital to final industrial and commercial users. The proper structure and incentives for credit-risk evaluation and management do not exist. To expand their scope of operations, MMMFs will have to change. As with banking institutions, credit-analysis capabilities must become an integral part of their operations.

In sum, the MMMF is a byproduct of a regulated market. With regulations being dismantled, the basis for their existence has disappeared. To compete in the marketplace, the funds will have to alter their structure. Failure to do so will result in a diminishing role for them in the economy's capital-allocation process.

Vincent G. Salvo

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS: 6 months ending	EXPORTS: change from year earlier	GNP IN 1981: in billions of dollars	GNP IN 1981: $ per capita	BALANCE OF PAYMENTS: latest data	BALANCE OF PAYMENTS: reserves (less gold) in million $	BALANCE OF PAYMENTS: 12-month change	BALANCE OF PAYMENTS: months of imports covered	BALANCE OF PAYMENTS: use of IMF credit, millions of dollars	BALANCE OF PAYMENTS: current influences on payments	MONEY AND BANKING: 12-month changes: latest data	MONEY AND BANKING: 12-month changes: consumer prices	MONEY AND BANKING: 12-month changes: latest data	MONEY AND BANKING: 12-month changes: money supply(M1)	MONEY AND BANKING: exchange rate in U.S. dollars, May 4, 1983	MONEY AND BANKING: change from year earlier, May 4, 1983	MONEY AND BANKING: current monetary conditions	COUNTRIES
Africa	Algeria	Homebuilding program for 1983 scaled down because of tighter budget situation.	Jan.	— 6%	36.0*	1,935	Feb.	2,296	—36%	1.0	0	Oil price cut by $5.00 per barrel to $30.50.	Dec. '80	+10%	Aug.	+22%	.2115	— 5%	Sonatrach to raise a $500-million Eurocurrency loan.	Algeria
	Cameroon	Douala port capacity to be increased substantially with $22.5 million World Bank loan.	March	— 4%	7.8	890	May	28	—68%	0.3	0	Ad valorem export duty to be lifted in case of commodity price fall.	Sept.	+11%	Sept.	+19%	.0027	—18%	Credit restraint continues.	Cameroon
	Egypt	Government to compensate for lower oil earnings by cutting expenditures and raising non-oil exports.	Nov.	+23%	30.8	710	Dec.	698	— 3%	0.8	56	Oil prices to be raised by 25¢-50¢ per barrel as of May 1.	Nov.	+14%	Dec.	+26%	1.2100	— 1%	World Bank loaned Egypt $472 million last year.	Egypt
	Gabon	Austerity measures are to be introduced following fall in oil revenues.	Dec.	— 5%	3.4	6,180	Sept.	309	+59%	30.5	10	Current-account surplus continues to shrink; overall deficit likely this year.	May	+20%	Sept.	+24%	.0027	—19%	Gross reserves decline.	Gabon
	Ghana	State expands its role in trading, banking, and insurance; textile company nationalized.	Dec. '81	—34%	n.a.	n.a.	Dec.	142	— 4%	2.0	17	Surcharges will be imposed on imports and bonuses given for exports.	Oct.	+12%	Dec.	+19%	.3636	0	Growth of money supply decelerates.	Ghana
	Ivory Coast	New 1981-85 Five-Year Plan assigns highest priority to modernization of agricultural sector.	Nov.	—28%	9.8	1,190	Dec.	2	—88%	0	516	Lower export receipts owing to bush fires in cocoa, coffee, and timber areas.	Dec.	+ 6%	Aug.	+11%	.0027	—18%	Debt service expected to claim 40% of exports in 1983.	Ivory Coast
	Mauritius	Austerity policy continues; 1982 real growth estimated at 6%.	Dec.	+34%	1.0	1,016	Feb.	39	+38%	1.0	167	Trade deficit halved in 1982 to $76 million, as export receipts rose 30%.	June	+12%	Jan.	+ 8%	.0902	— 4%	External debt service rising steeply.	Mauritius
	Morocco	World Bank to lend $127 million for irrigation projects and road building.	Oct.	—15%	15.2	735	Jan.	77	—14%	0.2	942	Govt. reduces number of goods that can be imported without restrictions.	Nov.	+ 7%	Sept.	+18%	.1513	—19%	Japan to lend $80.4 million for phosphates project.	Morocco
	Nigeria	Motor-assembly industry takes brunt of economic downturn, suffers wage-cuts and lay-offs.	Jan.	— 9%	86.8	1,125	Jan.	1,295	—51%	0.7	0	Oil output in April remains under 1 mbd —below 1.3 mbd OPEC target.	Sept.	+ 4%	Sept.	+ 5%	1.4450	— 3%	Acute foreign-exchange shortage continues.	Nigeria
	South Africa	Led by agriculture, 1982 real GDP declined 1%; upturn awaits export pickup.	Dec.	— 6%	77.5	2,573	Feb.	1,129	+31%	0.8	867	Imports of 1.5 mn. tons of corn foreseen this year, owing to drought.	Jan.	+15%	Dec.	+16%	.9195	— 3%	Inflation rate ebbs slightly.	South Africa
	Tanzania	Industry running at 15%-30% of capacity as country experiences severe economic crisis.	June	—31%	6.2	338	Nov.	7	—71%	0.1	80	Lack of imported inputs, retards export performance.	March	+34%	Nov.	+14%	.1036	— 2%	IMF proposes substantial shilling devaluation.	Tanzania
	Tunisia	Manufacturing output officially projected to rise by 12% this year compared with 3.4% in 1982.	Sept.	—15%	8.1	1,240	Feb.	511	—11%	2.0	0	Oil output averaged 100,000 b/d last year, down from 110,000 b/d in 1981.	Dec.	+14%	Nov.	+24%	1.5200	—14%	Claims on private sector rising steadily.	Tunisia
	Zimbabwe	Real output likely to fall by at least 3% this year after 2% growth in 1982.	Aug.	—11%	6.7	870	Nov.	137	— 5%	1.1	0	Sharp increase in foreign debt to an est. $1.5 billion at end-1982.	Oct.	+18%	Aug.	+12%	1.0400	—23%	Inflation accelerating.	Zimbabwe
Middle East	Kuwait	Budget for fiscal 1983/84 projects spending increase of nearly 4% to $12.1 billion.	Jan.	+ 8%	24.3	17,350	Feb.	5,631**	+51%	8.5	0	Official oil price cut to $27.30 per barrel, down $4.00 from January.	Sept.	+ 8%	Dec.	— 3%	3.4200	+37%	Syndicated lending in Kuwait picking up.	Kuwait
	Oman	Budget for 1983 forecasts deficit of $600 million; actual gap will be smaller because of underspending.	Oct.	— 5%	4.8	5,380*	Jan.	1,296**	+22%	9.4	0	Oil output avgd. 362,000 b/d in Jan.-Feb., 11% above same 1982 period.	n. a.	n. a.	Oct.	+16%	2.8970	0	Government borrowed $81.3 million for power station.	Oman
	Qatar	Budget for fiscal 1983/84 projects expenditures of $1.1 billion compared with $1.6 billion last year.	Jan.	—16%	6.0	24,000	Sept.	388**	+12%	2.3	0	Oil prices cut by $5.00 per barrel as of March 1.	n. a.	n. a.	Sept.	+18%	.2747	0	Growth of money supply slowing.	Qatar
	Saudi Arabia	Budget for fiscal 1983/84 projects expenditure of $75.7 billion, 7.2% over actual spending last year.	Jan.	—42%	155.8	16,719	Feb.	27,938**	—16%	9.7	0	Oil output averaged 4.2 mbd in Jan.-Feb., 51% below same 1982 period.	Sept.	— 1%	Sept.	+19%	.2900	— 1%	Royal decree designates only banks as stock brokers.	Saudi Arabia
	United Arab Emirates	Abu Dhabi to eliminate new projects worth $1 billion to trim 1983 budget deficit.	Jan.	—18%	29.8	29,780	Oct.	3,111	— 2%	4.3	0	Abu Dhabi oil output avgd. 700,000 b/d in Jan.-Feb.	n. a.	n. a.	Nov.	+ 6%	.2730	0	Abu Dhabi backdates 20% tax on foreign-banks to 1982.	United Arab Emirates

*1980 **Excluding state reserves

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World Interest Rates

market rates as of May 4, 1983; bond yields as of April 29, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.37	10.063 intervention rate	10.00	9.50	4.00	17.00 penalty rate 20.00	3.50	4.00	5.50
Day-to-Day Money	8.625 May 5	10.75	10.375	9.60	12.625	5.00	18.00	6.25	3.875 1-month Euro-Swiss fr. rate	6.188
Treasury Bills 91-day, Middle Rates	7.99	9.15	9.75	10.35	n. a.	n. a.	16.498 85 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.30 finance paper 15% tax w/h	9.30	9.90 Certified	12.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.20	9.17 15% tax w/h	9.688	9.90 Certified	not traded	5.65	18.95	no market	4.688	no market
Government Bonds Long-term, new and old issues, average yield	10.48	11.20	10.34	10.31	13.71	7.63	18.01	8.33	4.40	7.08
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	12.25	12.14	12.28	14.84	7.70	17.74	8.57	5.53	6.49
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.50	14.55	9.00	19.50 ⅛ qtrly fee on outstdng.	6.50	7.50	6.00
Bank Time Deposits 3-month	8.25 Cert. of Dep.	9.40	10.063	10.10	12.50	5.25	11.50	6.125 large deposits	3.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	8.938	9.313	10.188	no market	16.00	5.063	no market	5.563	4.563	6.313
Exchange Rates—in U.S.$ rates floating against the $	—	8161	1.583	.0205	.1351	.4090	.0007	.3641	.4856	.0042
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.343 *D*	1.112 *D*	1.463 *D*	7.106 *D*	4.010 *P*	16.327 *D*	3.406 *P*	4.613 *P*	2.652 *P*

Eurodollar Deposits
(London, interbank, bid)
May 5

7-day	8.688
1-month	8.688
3-month	8.750
6-month	8.813

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.514
U.S.-Canada Treasury Bills	−0.490
U.S.-Canada Finance Co. Paper	−0.330
Eurodollars-U.K. Local Auth. Deposits	−0.013

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.375
Over 7 yrs.	10.625
DM Bonds	
7 yrs. and under	7.50
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
432.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Mar.) 3.6	(Mar.) 7.2	(Mar.) 4.6	(Mar.) 9.0	(Apr.) 3.3	(Apr.) 16.6	(Mar.) 4.8	(Mar.) 2.3
Industrial production*	(Mar.) −1.8	(Feb.) −3.3	(Feb.) 2.9	(Feb.) 0.8	(Feb.) −5.6	(Feb.) −9.2	(Dec.) −8.5	(Mar.) −2.0
Trade balance† *(billions of local currency units)*	(Mar.) −$3.63	(Feb.) C$1.44	(Mar.) £0.38	(Mar.) −FF6.58	(Mar.) DM5.50	(Jan.) −Lit.2,620	(Mar.) −SF1.02	(Mar.) ¥679
Money supply (M1)*	(Feb.) 9.5	(Feb.) 9.6	(Feb.) 10.8	(Feb.) 10.7	(Feb.) 9.8	(Nov.) 17.4	(Mar.) 5.8	(Feb.) 6.4
Velocity of money (M1)*	(Dec.) −4.64	(Dec.) 0.54	(Dec.) −1.88**	Sept.) 0.58**	(Dec.) −3.66	(Sept.) 2.69**	(Mar. '82) 9.30**	(Dec.) 0.77
Reserves minus gold *($ million, change from previous month)*	(Mar.) 29	(Mar.) −363	(Mar.) −390	(Feb.) −2,364	(Mar.) 1,947	(Mar.) −676	(Mar.) 700	(Mar.) 259

* Percent change from 12 months earlier. ** based on GDP. † Figures are only for the month indicated.

Foreign Constraints Hinder Japanese Recovery

Japan is expected to show only a modest pickup in economic growth this year from 1982. And because continuing tensions between Japan and its major trading partners are likely to limit any rebound of exports, the economy will once again be forced to draw its strength from domestic sources. Any attempts to boost activity at home via stimulative monetary policy will be hamstrung by concerns over the behavior of the yen. Because of this, the Japanese government appears to be on the verge of slightly relaxing its previously rigid stance against stimulative fiscal policies.

Last year brought Japan another year of relatively sluggish growth: On a calendar-year basis, real GNP rose 3%—down from a revised 3.8% in 1981 and much slower than the 5.1% average recorded during 1976-1980. The slowdown was touched off in 1981 by unusually weak domestic demand. It was prolonged, however, by a collapse of some of Japan's key export markets starting in the fourth quarter of that year, which, in turn, set off another round of inventory adjustment. Exports of goods remained extremely depressed in 1982—despite a weak yen—in part because of the recession in the rest of the world, but also because of increased protectionist pressures aimed at Japanese products. As a result, in sharp contrast to 1981 when growth was overwhelmingly export-led, net exports accounted for only about 7% of the rise in real GNP last year (see chart, next page). This left domestic demand as the principal source of growth.

Fortunately, private consumption spending was particularly strong in 1982, rising 4.2% in real terms and contributing almost three-fourths of the overall growth in economic activity. This surprising performance can be traced to a decline in the savings rate and to a marked slowdown in inflation, which boosted real disposable income. Residential housing investment remained depressed for much of last year, although an increase in government financing spurred a revival of housing starts during the second half. Private plant and equipment investment by large businesses continued firm, but investment by small enterprises—which accounts for some 60% of total investment—remained depressed.

Despite signs that much of this weakness is continuing, there are a number of reasons to expect activity to pick up over the next several months. The most important forces include:

- The steep drop in international oil prices, which will boost the profits of a number of key industries using petroleum products as inputs and help to moderate inflation;
- A somewhat stronger yen, which will also improve the profitability of domestic raw-material-importing firms;
- Accommodative monetary policy and a slightly more expansionary fiscal policy, marked by a promise of an income-tax cut during fiscal 1983, which just began April 1; and
- Recovery in the United States and Europe.

Historically high unemployment, along with a freeze on government employees' salaries and the depressed state of business activity, is expected to hold the wage increase resulting from spring labor negotiations to around 5%. Provided that monetary policy does not turn overly expansionary, the decline in world oil prices and the anticipated stronger yen should keep the average rise in this year's consumer prices at about 2.3%—even lower than 1982's 2.7%—although some reheating can be expected toward year-end. This continued low rate of inflation—together with an income-tax cut and improvements in overtime, bonus payments, and employment as businesses start to recover—can be expected to result in a sufficient increase in real disposable income to support close to a 4% advance in real private consumption spending.

Residential housing investment is projected to rebound modestly, and businesses' currently-weak capital spending plans are likely to be revised upwards as profitability improves and the outlook brightens. Japanese exports will pick up some as the U.S. and European economies recover. But any increase is likely to be quite modest owing to the growing trade restrictions that have arisen from the continued frictions between Japan and its major trading partners. As a result, net exports are projected to make only a minor contribution to growth in 1983, and for the second consecutive year the economy is expected to be led by domestic demand.

All in all, Japan can be expected to record modestly faster real growth in 1983—perhaps in the neighborhood of 3.2%.

External affairs

Japan's trade surplus shrank to $18.2 billion in 1982 from close to $20 billion in 1981. Despite a markedly weaker yen, export volume fell more than 3%, primarily because of sluggish overseas demand arising from the world recession, but also because of increased protectionist restrictions and "voluntary" restraints on Japanese exports. In value terms, exports dropped 7.9%, registering the first year-over-year decline since 1953. Imports also fell—some 7.8% in value terms—owing to a decline in the price of crude oil, sluggish world commodity markets, the depressed state of the domestic economy, and a 7% decline in the volume of imported oil and oil products. Despite the smaller trade surplus, the current-account surplus widened to $6.9 billion from $4.8 billion in 1981 as in-

Foreign Constraints Hinder Japanese Recovery *(continued from page 7)*

creased income from overseas investments led to a much smaller deficit on the services account.

As for the capital account, 1981's capital outflow of $7.4 billion was more than doubled in 1982 for an all-time high net outflow of almost $16 billion. The large net outflow resulted primarily from sharply lower foreign investment in Japan, increased direct investment by Japanese firms abroad, stepped-up foreign lending by Japanese banks, and expanded issuance of yen bonds by foreigners. Reflecting the excess supply of yen, the overall balance was in deficit to the tune of $5 billion, and the exchange rate averaged 249 against the dollar, off 12.9% from 1981.

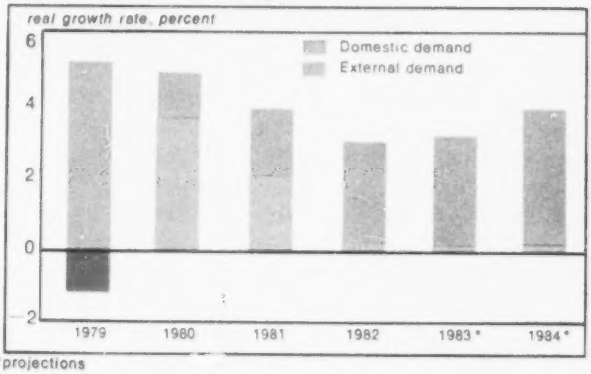
Recent statistics indicate that exports may have bottomed out and in all likelihood will respond to the pickup in activity in the United States and Europe in coming months. For 1983 as a whole, however, the increase in exports is likely to be a relatively modest 6%, with most of the rise contributed by price changes rather than higher volumes. Imports in value terms are projected to increase just over 1% in 1983. The oil import bill will fall drastically, with oil prices down some 15%. Government steps to boost imports are likely to have little effect, and non-oil imports are expected to rise only modestly as the economy recovers. As a result, the trade surplus is projected to expand to $25 billion. And assuming only a small widening of the deficit on services, the current-account surplus is expected to climb to around $13 billion.

Reflecting Japan's chronic excess of domestic savings over investment and the likely further liberalization of capital flows, the capital account is expected to record another large deficit, although not as large as in 1982. Any decline in foreign interest rates is likely to be swiftly followed by a decline in Japanese rates, which will, in turn, moderate any inflow of capital. The overall balance of payments is expected to be in approximate balance in 1983, and—reflecting the easier stance of the U.S. monetary authorities—the yen is projected to average a somewhat stronger 230 against the dollar.

Policy quandaries

Over the past year, Japanese policymakers have faced a difficult dilemma. Because of the government's strong desire to pare the fiscal deficit, monetary policy has been essentially the only policy tool available to spur weak domestic demand. However, any relaxation of monetary policy has only led to a weakening of the yen and heightened protectionist pressures. After stimulative money growth in the first quarter of 1982, Japanese monetary policy has turned successively less expansionary, as concerns have mounted over the weakness of the yen. And despite a dramatic appreciation of the yen from mid-November to mid-January, the less-expansionary monetary stance appears to have been carried over into 1983. Next month, however, is an election month, and with the domestic economy still weak and a record high rate of unemployment, pressures for a discount-rate cut have intensified. The Japanese authorities seem unlikely to cut the discount rate before a decline in U.S. rates gives them the leeway to do so without weakening the yen. However, the Bank of Japan is expected to seize any opportunity to ease monetary policy as soon as it is presented. Still, unless Japanese policymakers undergo another change of heart, any expansionary monetary tendencies over the next year are likely to be tempered by concern over the behavior of the yen.

The changing forces behind Japan's economic growth



*projections

On the other hand, fiscal policy may well be moderately more expansionary in coming months. The government finally has conceded that its goal of balancing the budget by the end of fiscal 1984 cannot realistically be achieved, and no new goal has been set. This gives the government some room for fiscal expansion. Although the budget for fiscal 1983 is unquestionably austere, political considerations, as well as concern about the domestic economy, prompted the announcement on April 5 of a package of stimulative measures. Similar programs in the past have supported existing levels of economic activity but had little stimulative effect; this package is not expected to be any different.

Potentially more significant, however, is the government's promise to cut income taxes during fiscal 1983. Persistent problems in selling Japanese government bonds make it difficult to see how income taxes can be cut significantly this year without first laying the groundwork for a new tax to offset the revenue loss. And given probable delays in implementation, a tax cut is unlikely to have a major impact in 1983. Still, depending on how the revenue loss is offset, such a cut could be significant, since it would be the first true fiscal stimulus undertaken by the Japanese in a number of years.

Melanie L. Lau